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PRIVATE EQUITY IN REAL ESTATE – TRENDS, PROGRESS AND CHALLENGES

MEENA KUMARI

Assistant Professor, Smt. MMK College of Commerce and Economics, Mumbai, Maharashtra, India

ABSTRACT

Private equity provides risk capital to mature businesses to meet their growth and expansion requirements. Private equity prefers to invest in those industries /sectors which demonstrate potential for high growth so that it can benefit from capital appreciation. Real estate is one of the rapidly growing sectors in the economy on the back of favourable demographics with a potential for further growth. Real estate sector has become the most preferred investment sector for private equity funds during 2005-10. However, there are certain problems associated with real estate such as lack of transparency, delays in execution of projects, illiquidity, difficulty in valuation, regulatory issues which have to be resolved for making successful investments. This article examines the concept of private equity, potentiality of real estate, private equity investment process, trends and progress, specific issues and challenges relating to real estate investments, measures to overcome such challenges.

KEYWORDS: Private Equity, Real Estate, Capital Appreciation, Transparency, Commercial, Residential, Regulatory Issues

INTRODUCTION

The term private equity refers to equity investment in growth oriented businesses, majority of which are unlisted. The capital is provided for medium to long term to enable such businesses to grow and expand. Private equity investors assume the role of active investors and work closely with their portfolio companies in strategy formulation, networking with customers and suppliers, syndicating with other investors to raise additional funds, explore new markets, acquire new businesses, diversify into new products. If the portfolio company reaches its growth potentialities, private equity investors make substantial gains in the form of appreciation in the value of their investments. If not, they might have to write off their investment. Thus, to ensure success of their investments, they prefer those companies which have the potential for earning high growth rates.

Real estate sector has provided huge opportunity for private equity investments. It is one of the major contributors to the growth of the economy. It contributed 6.3% to GDP in 2013 and has provided 7.6 million jobs. Housing and Commercial are its two subsectors with commercial further divided into retail, hospitality and office spaces. Housing subsector contributed 5 to 6% to GDP, while commercial subsector also grew alongside meeting increased infrastructure requirements[1]. Favorable demographic factors such as rising middle class, increased income levels along with rapid urbanization, migration to urban areas, increased commercialization led to the growth of real estate sector and attracted huge investments. In spite of rapid growth, substantial shortages due to supply demand mismatch still exist. The housing

[1] FICCI-EY Indian Real Estate Report (2013). Brave New World for Indian Real Estate: Policies and Trends that are altering Indian Real Estate, page 8.

shortage in 2014 is estimated to be 75.5 million units[2]though there is considerable oversupply in commercial retail space. This provides a huge investment opportunity.

Regulations also paved the way for private equity investments in real estate. Real estate was exempted from negative list of SEBI venture capital fund regulations in 2004, FDI regulations were amended to permit 100% FDI through automatic route in real estate sector. These developments enabled India to open up the sector for foreign investment. With RBI restrictions on bank lending for real estate projects, real estate sector also sought private equity funding.

OBJECTIVES OF THE STUDY

- To study Private equity investment process
- To examine the trends in private equity investing in real estate
- To study specific problems associated with investment in real estate
- To suggest measures to overcome such problems.

METHODOLOGY

The study is exploratory in nature. It focuses on the secondary data collected from various research reports, Government publications, News Paper reports, etc. The data collected is analyzed to obtain meaningful inferences.

Private Equity Investment Process in Real Estate

A private equity fund is a pooled investment vehicle. It is set up as a closed ended fund for a period of 8 to 10 years with capital contributed by Investors or limited partners. As per Alternate Investment Fund guidelines issued by SEBI, minimum investment contribution per investor is Rs. 25 lakhs. Their liability is limited to the amount of capital contributed by them.

The manager or general partner manages the private equity fund and takes decision to invest in a portfolio of real estate companies/projects. He is compensated by management fees during the life of the fund and a performance fees at the end of the funds life if certain performance targets are met. The investment period is the first 2 to 3 years of fund life, whereby investment worthy properties are sourced after a thorough due diligence. The general partner also aligns with project managers, advisors, valuation experts, legal experts as there may be procedural and legal complexities in each project. The funds are invested in residential real estate projects with the objective of achieving capital appreciation, in commercial real estate projects for earning lease rentals as well as capital appreciation. For making investments, private equity funds partner with developers of commercial or residential projects at the early stages of its development. The properties so acquired are actively managed for the next 5 to 7 years before they are sold.

The success of a private equity fund depends on the ability of portfolio company to increase in value after a period of time and in the ability of the fund to dispose of its investments in portfolio companies. Towards this end, the private equity fund manager plays an active role in assisting the portfolio company in realizing operating efficiencies. If investments in portfolio companies are sold at a higher price, profits are realized. Such profits are distributed to the investors and the fund is closed.

[2] CRISIL research (2010). India Real Estate Overview, page 5.

PRIVATE EQUITY INVESTMENT TRENDS IN REAL ESTATE

An analysis of private equity investments during the period 2005-10 reveals the following:

Table 1: Private Equity Investments-Sector Wise (2005-10)

Industry/Sector	Aggregate Investments
Real Estate and Infrastructure management	27%
Telecom	14%
Banking and Financial Services	12%
Power and Energy	8%
Information technology	7%
Pharmaceuticals, Healthcare and Biotech	4%
Media, Entertainment and Publishing	4%
Textiles and Apparels	3%
Automobiles	2%
Others	19%

Source: Grant Thornton

The above table shows that real estate is the most preferred industry sector during 2005-10 for private equity investments. The following table depicts private equity investment trends in real estate during 2006-13.

Table 2: Private Equity Investments by Value in Real Estate

Year	Investment Value ($ Billion)
2006	1.3
2007	6.8
2008	3.3
2009	0.9
2010	0.9
2011	0.9
2012	1.7
2013	1.4

Source: Grant Thornton, EY research.

During the pre global financial crisis period of 2006 and 2007, private equity investments in real estate were the highest. During this period the economic growth was robust, favorable demographic factors resulted in an increase in demand for residential and commercial projects. This attracted a lot of foreign private equity funds to invest in emerging economies like India. The investments were mostly in commercial real estate. Post financial crisis, there was a constriction in foreign flows and as a result the investments declined considerably. Though India was not affected by financial crisis as much as developed economies, there was a decline in economic activity resulting in a decrease in demand for residential and commercial units. Many real estate developers faced difficulty in completing the existing projects as additional funds were not forthcoming and delayed launching new projects. As the domestic demand improved, the residential sector recovered. Many private equity funds realigned their focus from commercial to residential projects. The private equity funds which invested at the height of the market in pre crisis period are now looking actively for exits as they have completed their holding period. The focus in 2013 was more on exits than on investments[3].

[3] Jones Lang Lasalle India Capital Market Report (2012). Reaping the Returns: Decoding Private Equity Real Estate Exits in India, page 12.

ISSUES INVOLVED

- **Illiquid Investments:** Real estate investments are illiquid as the property may not be easily sold at the end of the investment period and realize the cash flows. In some cases, private equity fund may have to wait till the improvements are carried out by the developer. Private equity fund should have the ability to withstand fluctuations in the value of investments and hold investments over long periods.
- **Difficulty in Valuation:** Real estate investments in unlisted firms are not quoted on any stock exchange, the value of such investments during their holding period is not known. There are no other cash inflows to the fund during the period of investment except the amount realized on sale. This in turn depends on market forces of demand and supply, specific requirements of buyer and seller, their respective negotiation positions. Thus, unlike public equity, there is no clarity on the amount that could be realized on sale of investments nor is there any clarity on the impact made by private equity fund on the value of investments till they are sold.
- **Lack of Transparency:** Till recently, real estate sector was unorganized with numerous small regional players financed by high networth individuals, lack of expertise. With the advent of institutional finance in 2005, the sector evolved in to an organized one. Still the sector is affected by lack of clear land titles, absence of title insurance, regulatory approvals and procedural difficulties. This increases the difficulty in execution of projects. Private equity funds must depend upon legal experts and consultants to evaluate specific problems involved in each project before taking the investment calls.
- Increase in input costs and delays in execution of projects: Rising input and labour costs results in shrinkage of profit margins thereby straining cash flows.
- **Effect of Economic Cycles:** Demand for commercial segment of real estate such as retail, offices and hospitality subsectors depends upon economic conditions. Accordingly more private equity funds are required during boom periods when more construction activity takes place and vice versa. In periods of low economic activity, the real estate sector faces the problem of oversupply, during which time the exit for private equity funds becomes difficult.
- **Exit Challenges:** Exit planning is required so as to return the capital to the investors after the end of the investment holding period. Residential projects are self liquidating as the units are sold to householders on their completion, hence exits happen naturally. However, exits have to be planned in case of commercial projects. Most prominent modes of exit in real estate are the following:

o **Sale through Public Market Sale (PMS) / Initial Public Offer (IPO):** IPO involves listing the stock of real estate company on the stock exchange and selling such stock or shares to the public on initial listing. PMS sale involves trading of secondary stock after they are listed on stock exchange. This is not a significant trend in India as it constituted only 5 % of total exits of private equity funds. Public response has not been very favourable to such listings except in case of highly reputed real estate companies.

  o **Third Party Exit:** This involves exit through sale to a strategic buyer or to another private equity fund. This constituted only 19% of total private equity exits on account of regulatory restrictions on sale of completed units.

- **Project Cash Flows:** Project generated cash flows are used to return the capital and provide returns to the investors. 21% of the private equity exits took place via project cash flows.
- **Promoter Buy Back:** This is also known as company buyback. Exit takes place when private equity funds sell their stake in real estate company to the promoter or the developer. This is a predominant form of exit as 51% of private equity exits were through promoter buybacks. The popularity of this mode of exit implies lack of other avenues for exit[4].

- **Regulatory Issues:** Following regulations caused hurdles in investment and exit by private equity funds:
  - As per FDI rules, there is a 3 year lock in for investments in real estate. This affects natural exit through project cash flows during the three year period.
  - In case of commercial projects other than industrial parks and Special economic Zones, restrictions on sale of completed units, exit is permitted only through sale to domestic investors / end users.
  - In case of a dispute with the developer or promoter, the dispute settlement procedure is not satisfactory. Regulatory policy is not conducive and restricts exit options to private equity investors.

MEASURES TO OVERCOME CHALLENGES

- To mitigate the risk due to delays in execution of projects and transparency issues, private equity funds focus on sound investment principles such as thorough due diligence, active monitoring of investments. Due diligence helps in determining project viability, asset quality, promoter / developer credibility, track record of successful execution of projects. Regular monitoring of the projects with hands on approach assume great importance in real estate investments as it ensures timely completion of projects, non-escalation of input costs which otherwise reduces the profitability and cash flow prospects.For thorough due diligence and active monitoring, the private equity fund manager should have knowledge of local conditions, domain knowledge, expertise in deal sourcing and deal execution.
- To tackle the problem of illiquidity and to generate sufficient liquidity for the fund, it is necessary to diversify investments across different property development cycles, different locations, different subsectors.Most of private equity investments in real estate projects are concentrated in metropolitan cities. NCR- Delhi and Mumbai attracted greater portion of private equity investments and exits in recent times.
- Real estate sector is cyclical in nature. Hence, private equity funds should time their investment and exit to market conditions of demand and supply so as to avoid the problem of high valuations at the time of investment due to high demand and lack of exits on account of oversupply during periods of low demand. Their investment strategy should be based on a thorough study of market conditions and should ideally invest during periods of low demand so as to benefit from low valuations and exit during periods of high demand.
- Regulatory hurdles have been addressed to some extent from recent measures adopted by the Government. Real Estate Regulation and Development Bill 2013 proposes to set up real estate regulatory authority in every state and arm such state bodies with the right to impose penalties on defaulters. This might bring about transparency and

[4] Ibid, page 13.

avoid delays in execution of projects. However, much needs to be done in arbitration and settlement of disputes between the fund manager and the developer.

- SEBI introduced draft Real Estate Investment Trusts (REITs) regulations in 2013. Apart from other things, this is expected to bring about transparency and provide exit option to private equity real estate funds. IPO market needs to be developed further to improve exit prospects.

CONCLUSIONS

Private equity funds started investing in real estate in 2005 when it has been exempted from SEBI negative list of investments and when FDI rules were amended to permit such investments under its automatic route. Real estate sector with its potentiality for high growth on account of favourable demographic and other factors was preferred by private equity funds. Private equity investments reached the peak levels in pre global financial crisis period but declined in the post crisis period on constriction of foreign flows and decline in domestic economic growth. The investments picked up on the back of robust domestic demand for residential real estate. However, certain sector specific problems are associated with real estate investments such as lack of transparency, illiquidity, increase in input costs, demand supply mismatch, difficulty in exits, regulatory hurdles. These can be mitigated to some extent by conducting thorough due diligence of projects, sound monitoring, selection of developers based on their credibility and track record, adopting project diversification techniques across various investments. Knowledge of local conditions and markets are considered essential for these purposes.

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